CONSUMER AUTONOMY

The ultimate power

Chapter 19
we generally prefer to feel ourselves sufficiently selective, critical, and maybe just downright cynical about them.

However, the claim to consumer rationality implies a clear yardstick by which we can measure the effectiveness of our actions. Does rationality imply something about the manner by which we make choices—collecting information about all the available products, for example? How much of this information is it rational to collect, given that the information-gathering process itself may be costly or time-consuming? Or does rationality only imply something about the outcome of choice—the absence of regret, or a perceptible increase in personal happiness, for example? These are not easy questions to answer.

The neoclassical economist cut through this complexity by positing the universal goal of utility maximisation. Consumers have varying personalities and preferences, but they are assumed to pursue a uniform objective: the pursuit of the greatest utility (or satisfaction) that is attainable with their disposable income. Rationality implies seeking and achieving that goal. At first sight, it seems a reasonable, if rather general, proposition. It implies that considerations of self-interest dominate all other influences in the consumption process. It implies that consumers have sufficient self-awareness to know which goods and services best suit their own needs and desires. It implies purposeful action.

Box 19.1

The neoclassical theory of consumer choice

The essential features of neoclassical consumer theory, in the simplest case of a consumer facing a choice between two commodities (say, bread and wine), can be summarised as follows:

**Assumed objective:**
The consumer seeks to maximise his or her utility.

**Given knowledge of:**
- the consumer’s income;
- the prices of the commodities;
- the consumer’s utility function which shows how his or utility depends on the quantities of bread and wine consumed.

**Deduce:**
The consumer selects the optimal commodity combination such that:

\[
\text{marginal utility of bread} = \frac{\text{price of bread}}{\text{price of wine}}
\]

\[
\text{marginal utility of wine} = \frac{\text{price of wine}}{\text{price of bread}}
\]

The marginal utility of a commodity is the additional utility the consumer derives from consuming one more unit of it. By consuming products so that their relative utilities 'at the margin' are equal to their relative prices, the consumer maximises utility.

The problem is that this assumption of utility maximisation may involve circular reasoning. Anything that consumers do can be held to be consistent with maximising utility. Consuming an addictive drug, for instance, may be deemed to satisfy one person’s particular needs. Making impulsive consumer decisions rather than carefully considered ones may be interpreted as utility maximising for someone who places a high premium on the time spent making choices—or on the thrill of a spontaneous and risky decision. Each of us has different preferences. So, it is difficult to establish that any particular patterns of choice are not self-interested and rational for the person concerned. Utility maximisation seems to look like a tautology: a proposition based on circular reasoning that cannot be refuted, and which therefore has no place in any enquiry purporting to be scientific.

What the utility maximisation postulate does for neoclassical theory is establish a common basis for the study of all consumer decisions. It offers a theory of the consumer to represent the behaviour of all consumers. In this way, is *Homo economicus*, the universal rational economic person, born.1

**MODELLING CONSUMER CHOICE**

Box 19.1 shows the formal process of modelling the consumption decisions of a utility-maximising individual. It considers the simplest case of a choice between two commodities. The consumer is deemed to be in an imaginary situation where there are just two commodities, bread and wine. It is the sort of (nonexistent) world depicted in the following stanza from the famous poem *The Rubaiyat of Perisan* by Omar Khayyam:

> A book of verses underneath the bough A loaf of bread, an ear of wine

> Be wise now sing in the wilderness

> Oh wilderness were paradise once!2

Forget paradise for the moment and just concentrate on the bread and wine. What balance between the two commodities will the consumer select? If the consumer’s income is limited, he or she will presumably seek a combination depending on their relative prices and their expected contribution to his or her satisfaction. This latter aspect can be represented in terms of a utility function, showing the extent to which different quantities of the two commodities contribute to the consumer’s total satisfaction. Utility is a function of (or depends upon) consumption; thus, the utility function mentioned in box 19.1 denotes the functional relationship between the consumer’s utility and the quantity of bread and wine consumed.

If the consumer has all the relevant information (that is, income, commodity prices, and the characteristics of his or her own utility function), the best selection may be deduced. What is this optimal combination of the two commodities? It is the combination at which the ratio of marginal utilities for bread and wine equals the ratio of their prices. Marginal utility is the additional amount of utility or satisfaction generated by the last unit of the product consumed—that is, by consuming one more loaf of bread or one more bottle of wine. Where the ratio of marginal
CONSUMER ECONOMICS

(First paragraph cannot be read naturaly)
law of demand. This states that the demand for a commodity tends to fall when its price rises, if other influences on demand remain unchanged. It is a generally acceptable proposition, although there are exceptions, such as when goods are purchased mainly for their "snob" appeal. It underpins the depiction of the demand curve introduced in the preceding chapter.

The simplest explanation of this proposition builds on the principle of diminishing marginal utility. This holds that the more units of a commodity a person consumes, the less additional satisfaction is derived from each successive unit. The standard example is that of a man who, having been lost in the desert and now dying of thirst, is offered successive glasses of water. The first glass gives enormous satisfaction; it saves his life. The second is delicious, the third very enjoyable, the fourth rather less so, and so on. Eventually, more water adds nothing to the man's well-being. By implication, the amount a consumer would be willing to pay for successive units of the commodity declines, until a point is reached at which the consumer is not willing to pay anything at all for one more unit.

Further reflection suggests two supplementary reasons for a generally inverse relationship between the price of a product and the demand for it. One is the substitution effect. A consumer is likely to substitute another commodity for one whose price has risen. If wine is rising in price, a consumer may buy beer or whisky instead. The other effect is the income effect. A rise in price of any commodity, particularly if it is one on which the consumer spends a substantial proportion of his or her income, effectively reduces that person's real disposable income. As a result, the consumer will be likely to buy less of the commodity—and less of other commodities, too. The two effects together explain the inverse form of the relationship between demand and price.

These kinds of consumer responses to price changes are observable in the marketplace. The ambition of neoclassical theory is to explain the underlying utility-maximising processes. It is not difficult to envisage the connection, based on the analytical devices introduced in Figure 19.1. The effect of a change in the price of a commodity on an individual's demand for it can be interpreted as a series of consumer equilibria, each equilibrium relating to a different budget line. For example, a fall in the price of bread (causing the budget line to 'hinge' outward to the right) enables the consumer to do one of the following: (1) buy more bread, substituting it for wine, which is now relatively more expensive; (2) buy either more of both bread and wine; or (3) perhaps buy the same amount of bread and take the benefits of lower bread prices in the form of more wine. It all depends on the consumer's preferences.

In the aggregate, though, one would normally expect that the higher the price of a product, the lower the demand for it will be—and the demand curve will slope down to the right. Eureka! The connection between the general law of demand and the theory of individual consumer choice is demonstrated.

This is the grand claim of neoclassical consumer theory: that it links observable empirical phenomena with theorising about the nature of consumer behaviour. Thus, it claims to 'go behind the demand curve' to reveal the fundamental features of rational choice. If individual consumer choices can be understood in this way, the arguments made, we can infer something, maybe quite a lot, about the processes underpinning the swings in the behaviour of consumers in the aggregate.

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**Box 19.2 Elasticity of demand**

Orthodox econometric provides a tool of practical value in measuring the responsiveness of consumer demand to changes in price, income, or other relevant variables. This is the elasticity of demand. It shows the responsiveness of demand for a commodity to changes in its own price.

If the proportionate change in demand is less than the proportionate change in price, the demand is said to be inelastic. This is typically the case where a product has no readily available substitute, especially if that product accounts for a small proportion of total consumer expenditure. Salt is a classic example. On the other hand, if there's change in the price of a commodity brings about a more than proportionate change in the demand for it, the demand is said to be elastic. This is the usual case where substitutes are readily available. Whether this is so depends, in part, on the breadth of definition of a commodity.

Thus, the overall demand for food or for clothing may be relatively inelastic, but the demand for particular types of food or for particular items of clothing is normally much more elastic.

This notion of elasticity is useful. Among other things, it is an antecedent to the popular view that sellers always make more revenue by raising the prices of their products. They will do so only when the demand for their products is inelastic. When the demand is elastic, the higher price will cause potential consumers to stop buying, so the total sales revenue will fall. So, if you are running a dance party, you do not necessarily make more income by raising the admission price. Similarly, a bookseller does not necessarily make more profit by raising the prices of the books. Evidently, knowing about elasticity is useful for sellers who have the ability to make independent decisions about their pricing policies.

Different measures of elasticity can throw the responsiveness of other variables, too. The income elasticity of demand, for example, measures the responsiveness of demand to changes in consumers' incomes. The own-price elasticity of demand measures the responsiveness of the demand for one commodity to changes in the price of others (how much the demand for wine responds to changes in the price of bread, for instance). Elasticity can be applied to supply, too: elasticity of supply shows the responsiveness of the supply of a commodity to changes in its price.

Measures of elasticity are useful tools for empirical research. However, their use for such practical purposes is quite independent of any connections with neoclassical economic theory.

**CONSUMER SOVEREIGNTY**

There is a normative dimension to consumer demand theory: this is because in primary in neoclassical economics embodies the consumer sovereignty principle. What does consumer sovereignty mean? To quote Paul Samuelew, the Nobel Prize winning...
CONCLUSION

Necological theory presents us with an elegant theory of consumer demand. In an age when "consumption" dominates, it is important to understand the interplay between economic factors and environmental considerations. The study of consumer behavior must also be linked with a study of business ethics, marketing, and consumer protection. Issues of corporate responsibility, sustainability, and social justice must be addressed.

Consumer decisions are influenced by a variety of factors, including personal values, social norms, and economic incentives. Understanding these factors is crucial for effective policy-making and business strategies. Economists and policymakers must work together to create a more sustainable and equitable system of consumption.

In conclusion, the study of consumer behavior is essential for the development of a more informed and responsible society. By understanding how consumers make decisions, we can work to create a world where environmental sustainability and social welfare are prioritized.
CHAPTER 20

Firms

Engines of efficiency?

What are firms? What do they seek? How do they get it?
How do neoclassical economists analyse firms?
Does this provide a useful guide to business behaviour in practice?

Firms are key players in the capitalist drama. Their behaviour shapes the overall character of the economic system. Whether firms are the drivers of exploitation and class inequality, as Marxists contend, or instruments for serving consumers' interests, as the neoclassical consumer sovereignty model implies, is a crucial question in any assessment of the capitalist economy. This chapter examines how firms are viewed within neoclassical theory, seeking to emphasise the distinctive underlying assumptions and the inferences drawn about business efficiency.

DIVERSE BUSINESSES: SINGLE THEORY

What are firms? Evidently, business organisations come in many shapes and sizes. Some are engaged in agricultural production, some in mining, some in manufacturing, some in finance, and some in the provision of services. Some are big, some small. Some are companies, some partnerships, and some sole traders. Some are transnational corporations, some are corner stores. Neoclassical economics attempts to build a single theory that applies to them all. Alfred Marshall paved the way for this with his notion of the 'representative firm.' Contemporary neoclassical economics textbooks develop this theme by presenting models purporting to show the universal features of business behaviour. This is not to claim that all firms are identical; rather, it is to assert that common principles underlie the differences in scale, organisation, and type of activity. It is a bold claim.3

Firms may raise capital in financial markets, they may hire their workers from labour markets, and they may sell their products in markets for goods and services; however, they are not markets. Their internal characteristics are based on non-market principles (hierarchy and command). The allocation of resources is determined by managerial fiat. As Stefano Zamagni puts it, 'In general, economic activity can be organised according to two modes, the market and the system of firms; the latter is the antithesis of the former.'4 Following this reasoning, one might expect the theory of the firm to be based on the study of organisational forms and power relationships. There have been some interesting developments along this line.5
MODELING THE PERFORMANCE OF A FINANCIAL MARKET

The performance of a financial market is often measured by its efficiency, which can be assessed through various indicators such as the speed of information processing and the degree of market liquidity. In this context, the Black-Scholes model plays a crucial role in pricing options and derivatives, providing a theoretical framework for understanding the behavior of financial assets.

The Black-Scholes model is based on several key assumptions, including the existence of a risk-free asset, the constant volatility of the underlying asset, and the continuous trading of assets. It provides a formula for the price of a call option, which can be expressed as:

\[ C = S_0 N(d_1) - X e^{-rT} N(d_2) \]

where:
- \( C \) is the call option price,
- \( S_0 \) is the current price of the underlying asset,
- \( X \) is the strike price of the option,
- \( r \) is the risk-free interest rate,
- \( T \) is the time to maturity,
- \( N(d) \) is the cumulative distribution function of the standard normal distribution,
- \( d_1 \) and \( d_2 \) are given by:

\[ d_1 = \frac{\ln\left( \frac{S_0}{X} \right) + \left( r + \frac{\sigma^2}{2} \right) T}{\sigma \sqrt{T}} \]

\[ d_2 = d_1 - \sigma \sqrt{T} \]

\( \sigma \) is the volatility of the underlying asset.

The model assumes that the underlying asset follows a geometric Brownian motion, which means that the logarithm of the returns follows a normal distribution. This assumption, along with the others, simplifies the analysis of financial markets but may not hold in all real-world scenarios.

The Black-Scholes model has been widely used in finance, but its limitations have also been acknowledged. For instance, it does not account for the possibility of jump discontinuities in asset prices, which can occur due to sudden events or market shocks. Despite these limitations, the model remains a cornerstone of financial engineering and continues to be an important tool for risk management and investment decision-making.
the point at which marginal cost equals marginal revenue. That is where the profit-maximizing output is attained.

Figure 20.1 elaborates on this basic model by introducing some diagrams (characteristic of neoclassical reasoning). They relate to the simplest case: a single-product firm in a competitive market. It is a short-run model in the sense that the firm can vary the quantity of only some of its factors of production (labour in this case); others (like land and capital) are assumed to be fixed in quantity. That is how the short-run

Diagram 1: Relationship between output of finished product and quantity of the variable factor of production (e.g., labour)

Diagram 2: Relationship between output of finished product and costs of production

Diagram 3: Examining the equilibrium output for the profit-maximizing firm in a perfectly competitive market

is defined, not as a particular time period, like a week or a year, but at the circumstances in which not all factors of production are variable. In the long run, all quantities of land, labour, and capital could be adjusted by the individual firm, but in the short run depicted here all the firm can do is vary the amount of labour added to the temporarily fixed factors of production.

Imagine the firm is a wheat farm. In the short run, a hundred hectares of land, one tractor, one combine harvester, and one storage barn are available to the farmer. How many workers should own the farm employ? If only one is hired, that worker will probably produce only a small output of wheat. It is possible that two workers could produce more than twice as much. If there are some benefits arising from cooperation between them in the production process. Perhaps a third worker would also increase the total output of wheat substantially. Eventually, however, extra workers are likely to produce smaller and smaller increments in production. This is because of the principle of diminishing returns. Formally, this states that, if additional units of a variable factor of production are combined with a fixed factor of production, after a certain point the additional quantity of output will decline. Refer to the diagram at the top left of figure 20.1. The principle of diminishing returns explains why the total product (measured on the vertical axis) rises at a slower rate as more labour is employed (measured along the horizontal axis). In the top-right diagram, the same processes are shown in terms of average and marginal product curves. The average product is the total product divided by the amount of the variable factor of production used. The marginal product is the additional total product resulting from the last unit of the variable factor of production used. Both rise and then fall as the initial benefits of cooperation are outweighed by the principle of diminishing returns.

One might infer that this principle of diminishing returns favours small-scale production over large-scale production. This is not so. When all factors of production are variable (in the long run), bigger firms may indeed be able to produce at lower average costs because of economies of scale. The point being emphasized here is that, in the restricted, short-run situation, if a firm tries to expand output by adding more of the variable factor of production to the fixed factor of production, it may raise its average costs of production per unit of output made. In the example of the wheat farmer, 501 workers on the 100 hectares, with only one tractor, one combine harvester and one storage barn among them, are unlikely to produce more wheat than 500 workers. By that stage, extra workers would simply be getting in the way of one another. In the extreme case, hiring extra workers would actually cause total production to fall, so the marginal product would be negative.

Another point to note about this analysis is that it is of a technical character. It concerns the relationship between average and marginal product. In the top-right diagram in figure 20.1, the marginal product curve cuts the average product curve at its highest point. Why? It is a matter of simple arithmetic, which any cricketer or baseball player will readily understand. Where a marginal score (in the last innings, for instance) is above the player's average score (for the season so far), the player's average scores, where the marginal score is below the average, the player’s average falls. The same reasoning applies to marginal and average products for a firm. So is the optimal output where the average product is at its highest? One might intuitively think so, but the identification of
environment in which they operate, whatever their individual inclinations. An efficient allocation of economic resources is the product of four forces:

- Firms must combine the factors of production efficiently given the existing state of technology and the prices of those factors of production. They must be producing at a point on the total cost curve rather than producing at a higher cost for the same level of output. Failure to do so can be expected to result in the firms being driven from the industry by firms who do use efficient production methods.

- Each firm must produce the most efficient level of output. ‘Marginal cost equals marginal revenue’ is the optimizing rule. As in the story of Goldilocks, it is a matter of ‘not too little, not too much, but just the right amount’. All profits opportunities are taken, but respect for the principle of diminishing returns ensuring that firms do not seek to expand output by using inefficiently large amounts of the variable factors of production.

- The total number of firms in each industry also tends to be ‘just right’ in the long run. If existing firms are making substantial profits, new entrants will be attracted to the industry. The extra output supplied by these new firms would then add to total supply and thereby drive prices down until the excess profits were eliminated. If the process were to ‘overshoot’ and firms started to make losses, the firms would leave the industry, thereby reducing supply. This would raise the market price to restore normal profitability levels to be restored. ‘Normal’ in this context means a rate of return on capital that is just sufficient to keep the firms in the industry.

- The consumers obtain the product at the lowest possible cost, given the prevailing state of technology and factor prices. Because firms must combine factors of production efficiently and produce optimal output levels, the prevailing market price is kept at the minimum. Thus the ‘consumer sovereignty’ assumption reappears in a yet more attractive guise: not only do consumers’ choices signal what is to be produced, but consumers acquire their goods and services at the lowest prices consistent with sustaining the necessary levels of production. It seems a thoroughly admirable state of affairs.

Whether these attractive features are manifest in reality depends on whether conditions in the real world approximate those assumed in the theory. There are pervasive reasons to expect otherwise. In practice, capitalist businesses may use their power over economic resources to suppress socially beneficial technical innovations, to limit the freedom of entry of new firms, to otherwise reduce or eliminate market competition, or to influence government policy to serve their interest at the expense of other community concerns. Such conduct implies a quite different normative assessment of the attractiveness of the ‘free-enterprise’ system. Exploiting its significance requires going beyond the view of the firm as an atomistic unit operating in a competitive economic environment to a more ‘realistic’ view of firms in practice.

Herrn gives us an overview concerning neoclassical theory. The theory of the firm is presented by economics textbooks as a means of modelling the behavior of capitalist businesses. Yet it is remarkably inert to the concern by capitalist businesses in practice to re-shape their economic environment in order to loosen the constraints on their activities imposed by competitive markets. Ironically, the neoclassical theory’s greater value may be for the organisation of a planned non-capitalist economy. In other words, the decision rules for determination of price and output (and the criteria for assessing allocative efficiency) may be more appropriate as socialistic planning tools than as measures of understanding actual capitalist businesses.

CONCLUSION

The neoclassical theory of the firm—typically taking up many chapters in neoclassical economics textbooks and presented only in brief outline here—is an elegant edifice. As the core of orthodox economic thinking about business behaviour, it warrants careful consideration. Like the theory of the consumer, it is based on some distinctive assumptions about rationality and the nature of the environment within which economic decisions are made. It presents a general view of firms as calculating and competitive, as instruments for making choices conducive to clearly defined goals. Also like consumer theory, it seeks to link behavioural postulates, such as the quest for profit maximisation, with empirically measurable constructs, such as supply curves showing how much firms will produce at different market prices. Elasticity of supply is a measure of the responsiveness of output to price changes—another obvious parallel to demand elasticity in consumer theory.

The theory of the firm is more than an exercise in geometry; it also seems to convey a powerful message about the nature of a ‘free-enterprise’ capitalist economy. It emphasizes the relentless pressures for efficiency and the essential subservience of business interests to those of consumers. As such, it is the basis for a powerful economic ideology. The question is: how much of it starts to unravel as the simplifying assumptions of the theory are relaxed? The assumptions of perfect competition is particularly crucial in this respect, as the following chapter reveals.
The Ideology of the Market

[Diagram of aggregate demand and supply curves]

The smallest deviation from the perfectly competitive extreme takes us into the realm of monopolistic competition. In this market situation there is a large number of small farmers producing an identical crop and where there are low barriers to entry (e.g., just the initial cost of acquiring the necessary land and tools), may approximate it. Some financial markets, where there are numerous buyers and sellers, each too small to influence market prices, may have some of these competitive characteristics, too. But these are exceptional instances.

The centrality of perfect competition theory in neoclassical economics has led us to do with its real-world relevance with its analytical elegance and its pointed ‘ideal’ normative properties. Perfectly competitive markets are held to be ‘ideal’ because they ensure maximum efficiency in use of factors of production, continuous adjustment of market prices to changes in the conditions of demand and supply, and the elimination of any excess profits that would result from the exercise of monopolistic power. Perfect competition is not a common market structure in practice because it is normally in the interest of firms to deviate from this ‘ideal’—to differentiate their product, to seek to establish consumer loyalty, and so erect barriers to the entry of potential competitors. Such behavior tends to result in monopolistic competition, oligopoly, or monopoly.

MONOPOLISTIC COMPETITION

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Perfect Monopoly

As global media magnate Rupert Murdoch says, "monopoly is a terrible thing, yet you have it.

Strictly defined, perfect monopoly is the polar extreme of perfect competition. This is where there is only one firm supplying the product in question: the firm is the industry. It will maintain its monopoly position by imposing barriers to the entry of new firms. It will also take advantage of its monopoly position by restricting output and raising prices in order to generate maximum profit.

So, the prevailing market price will be higher than that under perfect competition—assuming that production costs are the same in either case. That is the basis for neoclassical economists’ critique of the presence of monopoly. It does this with the popular presumption that monopolies tend to exploit their economic power by charging higher prices for their products.

Whether markets that are more competitive do actually generate lower prices depends crucially on the level of production costs. The foregoing case against monopoly rests on the assumption that an industry's production costs would be the same irrespective of whether it is organised as a monopoly or as perfect competition.

This is not necessarily the case. A monopolist lacks the incentive to minimize costs that firms have in perfectly competitive market situations. However, a monopolist usually has more resources at its disposal to invest in new technologies, and product and process innovations, if so wished. Because the costs of production may be either higher or lower for the monopoly in practice, we cannot know for certain how the prevailing price level compares with the perfectly competitive norm. All we can say with confidence is that, whatever the costs of production may be, monopolies have the capacity, unless constrained by government regulations or faced with a highly elastic demand for their products, to seek higher profits by raising prices.

This illustrates a general feature of the neoclassical theory of market structures. Only in the perfectly competitive case does the market structure actually determine the conduct and performance of the firms. The further one deviates from this norm, the greater the scope for firms to engage in strategic actions, which, by its very nature, is harder to model and predict. This is particularly so for oligopoly, where the uncertainties associated with the perceived interdependence of firms are most striking.

Neoclassical economists have sought to apply game theory in this context in order to "graft" some models of strategic behaviour to this helps to inject some realism into the analysis of business behaviour, but at the price of producing more uncertainty about the predicted outcomes. The general problem remains: the greater the departure from the perfectly competitive 'ideal' and the closer the approximation to 'real-world' market situations, the less effective is neoclassical theory as a means of explaining and predicting market behaviour.

In discussing the features of different market structures, the term "monopoly" is often used interchangeably with "imperfect competition." In other words, it is used to refer to any market situation in which firms have the capacity to significantly differentiate their products, command some degree of "brand loyalty" among their customers, impede the entry of new firms, or otherwise mould the operations of the market to their own interests. This is a much broader use of the term than that of "pure" or "perfect" monopoly, where only one seller exists. It is a use of the term associated with the concern to understand business behaviour in all contexts—other than the idealised perfect competition—so as to decide what to do about it.

Structure, Conduct, Performance

The orthodox economic approach assumes that the structure of a market shapes the conduct and performance of firms operating within it. In a perfectly competitive structure, firms' conduct is necessarily that of the price-taker; therefore, their performance depends on efficient resource use in the process of cost minimization, and their capacity to make profits is always constrained by the actual or potential entry of new firms into the industry. The structure of monopolistic competition, on the other hand, allows for more competitive conduct through price and product differentiation—although firms' ability to generate high levels of profit is still constrained by the relative ease of entry.

In oligopoly, the structure makes strategic conduct a business imperative, and successful performance in these strategic games is usually rewarded with substantial profits. In conditions of pure monopoly, the structure imposes no requirement on the firm to act energetically, other than to continually secure its own monopoly position, and its profit performance can be enhanced by monopoly pricing (subject to the constraint imposed by the elasticity of demand).

This structure-conduct-performance approach to understanding business behaviour embodies a distinctive interpretation of what competition means. It is treated as an end state—a consequence of market structure rather than a process. A conflict may be made with Adam Smith's conception of competition as a process of rivalry, such as that between producers in different locations. This alternative, more dynamic, view of competition has strong echoes in Marx, Marshall, and the Austrian tradition of economic analysis, from Menger through to Schumpeter and Hayek. It places more emphasis on entrepreneurship as an active element in business behaviour. Entrepreneurship is the process by which firms create business opportunities. It is a means by which firms pursue values in business behaviour. It has no equivalents place in the standard neoclassical approach, notwithstanding the common (and confusing) reference to the firm as the "entrepreneur." Rather, in neoclassical theory, the essence of competition is understood to be determined by the industry structure, particularly the number of firms in the industry in question. In practice, whether the number of firms is the key determinant of the extent and form of competition is a moot point, even the notion of an "industry" comprising firms making similar products is untenable with the development of businesses that have multiple industrial interests.
Box 21.2

Competition policy

How much competition among firms supplying goods and services is necessary, desirable, or possible? How concerned should governments be about enforcing competition? Heres lie two basic issues. The case for a capitalistic market economy relies on the positive link between competition, efficient resource allocation, and consumer welfare. Yet, ever since Adam Smith, it has been recognized that the forces of competition can be continually frustrated, even thwarted, by the forces of monopolization. Governments have sought to deal with these tensions by having national competition policies.

Legislative restrictions and regulations have generally sought to preclude business practices such as:

- anti-competitive agreements and exclusionary practices, including primary and secondary boycotts
- misuse of market power, such as charging excessively high prices
- exclusive dealings, such as when a large firm insists its suppliers do not deal with other firms
- resale price maintenance, whereby manufacturers insist on the price at which retailers sell their products, and
- mergers that have the likelihood effect of substantially lessening market competition.

In recent years, governments subscribing to neo-liberal principles have extended national competition policies to previously exempt areas such as public utilities. In effect, competition policy thereby becomes linked to the push for privatization—either directly transferring public enterprises into the private sector through the sale of their assets or requiring public enterprises to act more like private-sector enterprises, basing on 'comparable market' for the provision of all services is a recurrent theme. The declared aim is to enhance efficiency of the providers of public services. In practice, it usually results in services previously provided by public enterprises (such as electricity and gas supplies) and local government being 'contracted out' to private-sector firms, and the renunciation of community service obligations that previously guided the behaviour of the public enterprises.

The Organisation for Economic Cooperation and Development (OECD) has been trying to promote 'convergence' of national competition policies in different nations. It stresses the importance of transparency and non-discrimination in enforcement, and the need for competition laws to be applied uniformly with a minimum of exceptions. This has the appeal of creating a so-called 'level playing field' for business, but in practice it can mean a level playing field on which transnational corporations can extend their domination. The tension between the principles of competition and the political economy of capitalism in practice becomes ever greater.

CONCLUSION

Competition policies in practice oscillate between attempts to influence structure, conduct, and performance. However, closer investigation indicates some fundamental problems with this body of analysis. The models quickly become 'open-ended' in what they have to say about expected business behaviour as soon as the perfect competition model is set aside. The result is that the precision sought by neoclassical theorists cannot be achieved, except by making some truly heroic assumptions (such as costs of production being independent of market structure).

These difficulties also limit the use of the theory of market structures in the formulation of public policies. How best to promote business competition and limit monopoly power? No clear policy prescriptions emerge, despite the strong commitment to the perfectly competitive 'ideal'.

In the end, one has to wonder what the point of the theory is. Is its purpose to describe (or at least approximate) real-world market structures? Is it meant to provide a normative ideal that can be used as a basis for policy formulations? Or is there a yet more contentious purpose: to provide an ideology that diverts attention from the actual structures of economic power, thereby serving as a legitimizing device for capitulation instances? These three possibilities apply not only to the theory of market structures, but also to neoclassical economics as a whole, including what it has to say about the distribution of income between land, labour, and capital.
Explain the distribution of income.
Looking first at the demand side, a formal statement of the relevant variables is presented in box 22.2. The objective of cost minimisation is the assumed starting point. This is necessary but not sufficient condition for the general goal of profit maximisation (as discussed in chapter 20). To minimise costs, each firm needs to know what volume of output it is aiming to produce, the ways in which it is technically possible to combine the various factors of production, and the prevailing prices of these factors of production.

**Box 22.3**

The neoclassical theory of the demand for factors of production

The essential features of a firm's demand for factors of production can be set out as follows:

- **Assumed objective:**
  The firm seeks to minimise costs.

- **Given knowledge of:**
  - the volume of output produced by the firm;
  - the production function, showing the relationship between what combinations of factors of production (labour, capital and land) can be used to produce the required output;
  - the prices of the factors of production.

- **Demand:**
  The firm employs factors of production such that the ratio of their price to their marginal productivity is equal. So, considering just two factors, labour and capital:

  \[
  \text{marginal productivity of labour} \cdot \text{price of labour} = \text{marginal productivity of capital} \cdot \text{price of capital}
  \]

  The marginal productivity of a factor of production is the extra amount of output generated by employing one more unit of that factor in comparison with the other fixed factors of production. Where the ratio of the marginal productivities is equal to the ratio of prices of those factors of production, the firm has an optimal capital-labour ratio, according to this theory.

The first of the information requirements listed in box 22.2 is particularly important. Firms do not employ factors of production other than at a mean to an end, and the end is producing goods and services for profit. The significance of this is that the demand for a factor of production is a derived demand: it derives from the demand for the product that it is made into. To illustrate the point, consider a firm that has already decided on the level of output to produce, following the procedure described in chapter 20 (or, more precisely, acting as if it followed those steps). If the firm enjoys a monopoly position, according to the reasoning in chapter 21, its demand for factors of production would be less than that of an equivalent firm in an industry organised on the principle of perfect competition. Because a monopolist can be expected to restrict output and raise the price of its product, its derived demand for factors of production is correspondingly reduced—other things being equal. So, the primary influence on the demand for factors of production is the output of the firms employing them.

The second influence in the rate of technology, as shown by the production function. There are usually alternative ways of producing a particular output—whether by capital-intensive or labour-intensive methods of production, for example. Selecting from among these options requires a firm to have information on the relative factor prices. At first sight, this is a strange data requirement, since the point of the analysis is to explain how the demand for the factors of production influences their prices. It seems that we need to take as given what we are seeking to explain. The consensus is resolved by recognising that, according to neoclassical theory, the aggregate demand by all the firms for each factor of production determines its market price, but that, once established, the market prices must then be taken as given by individual firms. Essentially the same model-building methodology that was applied to the study of consumer demand (in chapter 19) and the theory of the firm (in chapter 20) is now applied to the study of factors of production.

Finally, given all this data, the cost minimising firm determines the particular production method that satisfies the decision rule shown in box 22.2: it employs factors of production in such proportions that the ratio of the marginal product of any pair of them equals the ratio of their market prices. Marginal product is the extra quantity of output generated by hiring one more unit of a factor of production. So if, say, labour costs twice as much per unit as does a unit of capital (setting aside for the moment how these units are measured), then it makes sense to employ labour and capital in the proportions that ensure the productivity of the last man employed is twice that of the last unit of capital. This is cost minimisation achieved.

It is pertinent to note in passing that this analysis regards cost minimisation by firms as essentially a matter of making wise choices about optimal combinations of land, labour, and capital. There is no concern here with the actual processes of managing the factors of production—labour in particular—which are a concern in Marxist analysis, for example (as discussed in chapter 14). Rather the efficient management of resources is simply assumed (and class conflict in the workplace is assumed away) for the purpose of building a model to explain how much land, labour, or capital will be employed. The focus here, as elsewhere in neoclassical theory, is on choice rather than on conflict or coercion.

If each firm decides on the quantity of each factor of production it would employ at each price, the total can be added to determine the aggregate demand for each factor of production. Thus, the demand curve, as shown in box 22.1, can be constructed. A downward slope to the right indicates that the higher the price of the factor of production, the less it will be demanded. The nature of this relationship is shaped by both substitution and output effects (analogous to the substitution and income effects in the analysis of consumers' demand considered in chapter 19). A high price for a factor of production will encourage firms to adopt production technologies that use little of that factor—so they substitute cheaper factors of production for the high-priced one. This is the substitution effect. A high price of a factor of production also increases firms
REVISING PRODUCTION

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POWER

UPDATE 1

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Page 2 of 3

The Reader's Guide
Third, these are fundamental economic problems with the attempt to theorize income distribution in terms of the productivity of labour, land, and capital. What the neoclassical theory must do, if it is to be consistent, is relate the income of each factor of production to an empirical measure of its productivity. Rent must be shown to reflect the measured productivity of land; wages must be shown to reflect the measured productivity of labour; and profits must be shown to reflect the measured productivity of capital. Unfortunately for neoclassical theory, this cannot be done.

Part of the problem is that of distilling the relative productive contributions of land, labour, and capital when all (or even just two) of the factors must be combined in order to produce goods or services. This difficulty may be addressed (as theory) by holding one factor constant and observing the impact on output of variation in other factor(s) at the margin. In practice, the empirical measurement of marginal products is usually difficult, if not impossible, to achieve.

Yet more fundamental is the conceptual problem of finding consistent units of measurement for each of the factors of production. This is not a major difficulty in relation to labour: inputs of labour can be measured in terms of person hours of work, so the reward to labour can be expressed as a wage rate per hour and related to the productivity of that hour’s labour. It is also possible for land inputs of land can be measured in terms of hectares; so the reward to land can be expressed as a rental per hectare and related to the productivity of that land. However, no such physical measure exists for capital. Capital goods comprise diverse items—machinery, equipment, tools, plant, and buildings—for which the only common measure is their market value. However, that market value is not independent of the profitability of the firms using those capital goods. And there is the rub. Because the “productivity” of capital goods affects their valuation, measuring a rate of return on capital involves circularity. Wherever there is profit, capital has a higher market value; where it is unprofitable, capital has a lower market value. So, the estimated rate of return on capital is not independent of the valuation of the capital input.

This last point may seem somewhat esoteric, but its economic significance is substantial. It means that the neoclassical attempts to establish a theory of distribution that links land, labour, and capital in a symmetrical fashion is ultimately unsuccessful. Profit cannot be treated as a payment for the productivity of capital in the same way that wages reflect the productivity of labour or rent reflects the productivity of land. The root problem here is the attempt to eradicate the notion of an economic surplus from economic theory. In the classical and Marxian economic traditions profit is treated as a surplus, arising after wages, rent, and other costs have been deducted from revenue. It is the neoclassical economists’ attempt to explain profits in terms of the marginal productivity of capital rather than the class power of capital that is so deeply problematic.

Entrepreneurship may be posited as a fourth factor of production, as one means of trying to escape the conceptual problem of defining and measuring a return to capital. Profit can then be expanded as a reward for entrepreneurship, reflecting the skills of capitalist managers in organizing the other factors of production, innovating, and taking

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Box 23.3

Joan Robinson (1903–83)

At last a famous female economist! The economics profession has been dominated by males, but not exclusively. Joan Robinson is probably the most distinguished female economist, certainly from the political economy perspective. She was a student and, subsequently, a colleague of John Maynard Keynes at Cambridge University. As various stages of her career she made substantial contributions to neoclassical economics, Keynesian economics, Marxist economics, and post-Keynesian economics.

Her early work adapted neoclassical theory in the light of the growth of big business, providing the foundation for a theory of “inertial competition.” Her analysis remained constrained by neoclassical assumptions but showed that “exploitation” could result from firms with market power depressing wage rates below the level that would prevail under perfectly competitive conditions. This gave a slightly radical twist to the orthodox theory.

She became a significant figure in the formulation and teaching of Keynesian ideas. Her Introductions to the Theory of Employment (1937) was a point of access. Her subsequent books, particularly An Essay on Marxian Economics (1942), took an anti-capitalist turn, although her embrace of Marxism was less than complete. The labour theory of value had no place in her political economy because she thought it unnecessary as a basis for understanding profits and the exploitation of labour. Indeed, she held that any theory of value, by its very nature metaphysical, was an impediment to understanding capitalism in practice.

Her book The Accumulation of Capital (1956), which reflected the influence of the Polish political economist Michał Kalecki as well as Marx, developed the analysis of economic growth. Turning her attention to the critique of neoclassical theory, she also made important journal articles that demonstrated the incoherence of the orthodox theory of income distribution. She showed that the marginal productivity theory rested on a concept of capital that was theoretically unrooted and not amenable to measurement, arguing that this was a reflection of a deeper problem—the algebraic character of neoclassical economics. She launched many other attacks on orthodoxy, repeatedly stressing the need to tackle the neoclassical theories on their own terrain by showing the logical flaws in the reasoning.

Joan Robinson took the view that economics should be considered a “realist.” In her judgment, the best introduction for students would be to combine the study of economic history, the history of economic thought, and economic statistics.

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risks in the process of running their businesses. In effect, this means distinguishing between commercial profits and the rents routinely market-determined interest payments that are the reward for capital (in its economic form). This usefully acknowledges the dynamic element in business management. However, the analytical difficulty
GENERAL EQUILIBRIUM

ECONOMIC WELFARE AND NEGLECTED RIGHTS

CHAPTER 23
possibly leading to changes in those commodity prices, consequent changes in the demand for the factors of production used in making them, and so on. A change in one marker can cause changes in many others.

The notion of general equilibrium draws attention to the interdependence of markets in the economy as a whole. It may readily be conceded that, at any particular time, general disequilibrium is the normal state. However, according to neoclassical theory, market adjustments operate relatively independently of the direction of existing general disequilibrium, even though the system is unlikely to ever reach equilibrium before it is disturbed by other "shocks." The analogy of the ball on a saucer, introduced in chapter 16, is pertinent here: too if the saucer is frequently knocked or shaken, the ball will keep moving, but it will always tend towards the middle of the saucer. A general equilibrium that is unique and stable has a similar character. It may be achieved, if ever attained, but it is a condition on which the economy continuously tends.

This notion of general equilibrium, though abstract, is an influential way of envisaging the economy as a whole—as a network of interdependent markets producing overall stability. As the head of neoclassical tradition, working in the tradition pioneered by Leon Walras, general equilibrium theory has been developed into a sophisticated mathematical model. It is a model that typically takes as given some key socioeconomic conditions: consumers' tastes, the state of technology, the ownership of economic resources, and workers' preferences between income and leisure. There affect, respectively, the demand and supply for goods and services, the distribution of income, and the supply of labour. Critics argue that the model takes as given the key variables that really need to be explained. Mathematical precision evidently comes at a high price in terms of practical relevance.

From a political economist's perspective, what is more important than the technical specifications of general equilibrium theory is the vision it presents of a self-regulating market economy. This is its normative application—the basis for the belief that markets are the best means of economic organization. As such, it has a powerful ideological function supporting laissez-faire principles.

WELFARE AND OPTIMUM

Whether an equilibrium situation constitutes an optimum condition requires more systematic consideration. A market economy may or may not have an underlying tendency towards general equilibrium in practice; but, even if it does, this does not necessarily refute the case for economic planning or other forms of state policies. A world of general equilibrium, should it ever exist, would not necessarily be desirable in all respects. The continual flux in the process of adjustment to new equilibria may have undesirable social consequences—insecurity in employment, for example. The general equilibrium situation itself may have some socially undesirable features, such as a highly inequality distribution of income, or excessively high prices for particular goods that society considers necessary or in some way meritorious. An equilibrium situation is not necessarily an optimum situation.

Explicit normative standards are required if economists are to pronounce systematically on what is optimal. Yardsticks are needed against which progress towards more desirable outcomes can be measured, particularly if economists are concerned to be relevant to public policy discussions. It is for these reasons that neoclassical economists developed welfare economics—as a bridge between the analysis of what is and the discussion of what ought to be if the economy is to better serve social goals.

A.C. Pigou, who succeeded Alfred Marshall as Professor of Economics at Cambridge, laid some important foundations in his book The Economics of Welfare. He recognized that economic welfare (or well-being) is only one aspect of broader societal goals. Economic welfare is not synonymous with social welfare. Nor is it independent of the distribution of income. If, for example, the principle of diminishing marginal utility applies to income in general, a strong case for egalitarian redistribution can be made. The last dollar received by a rich person is likely to add little to his or her economic well-being, whereas an extra dollar received by a poor person is likely to add significantly. The rich person may not even notice that marginal dollars, whereas for the poor person it may be the difference between eating and starving. The obvious prescription is to redistribute income from the rich to the poor in order to increase total economic welfare—indeed, to continue that process of progressive redistribution until the marginal utility of income is equal for all citizens.

This seems to be a rather radical policy prescription, argued from an impeccable orthodox economic stance. Not surprisingly, it is not the sort of economic reasoning universally acceptable to the wealthy. Nor to other neoclassical theorists, who attacked Pigou's underlying logic. "Interpersonal comparisons of utility are illegitimate," they asserted. We cannot know for sure how much the dollar taken from the rich person will reduce his or her welfare. It may do so substantially if, for example, the rich person is a miser who is deeply distressed at having that dollar taken away. On the other hand, the poor person may be an individual with no economic aspirations, who is quite content with a meagre income and will derive little, if any, pleasure from the extra dollar. So we cannot say for sure that the posited income redistribution adds to total economic welfare. Perhaps there is no systematic way of comparing people's subjective well-being. The prohibition on interpersonal comparisons of utility is the apparent conclusion. However, this leaves no obvious basis for making judgments about appropriate public policies. If interpersonal comparisons of utility cannot be made, orthodox economists conclude, we can only say that a redistribution of income (or any other change) constitutes an improvement if it makes some person (or people) better off without making anyone worse off. This is the Pareto principle, named after the Italian economist Vilfredo Pareto. It is much weaker than the principle underlying Pigou's reasoning. Is it a useful guideline? On the one hand, it is unobjectionable in the sense that it seems to have no significant exceptions—if you are better off and no one is worse off as a consequence (or even if very few are), then it seems reasonable to conclude that we are collectively better off. On the other hand, it is only rarely applicable in the real world—almost every economic change generates both winners and losers, and in such circumstances the Pareto principle cannot tell us if the change constitutes a general improvement. It is a deeply agnostic position.

Responding to these difficulties, other welfare economists in the twentieth century developed supplementary principles based on compensation payments. For example, if a person or persons who benefit from an economic change can financially compensate the losers such that the latter feel no net disadvantage as a result, then that change may...
Cost-benefit analysis

Most economic decisions generate both social costs and social benefits. Cost-benefit analysis is a means of comparing these beneficial and adverse consequences in order to determine whether the expected outcomes are, on balance, in the public interest. It has become a widely used method for evaluation of public investment projects.

The procedure involves five steps:

1. Identify all the relevant consequences of a particular policy decision.
2. Measure all the consequences in monetary terms, so as to derive values for the costs and benefits expected to accrue to society as a whole.
3. Estimate the net present value of the future costs and benefits.
4. Compare the net present value of the costs and the net present value of the benefits, that is, the overall cost-benefit ratio.
5. Select all the policy alternatives where the cost-benefit ratio is less than 1; or, in the case of mutually exclusive alternatives, select the policy alternative with the lowest cost-benefit ratio.

Consider the construction of a new urban freeway, for example. The first step would require the analysis to list all the likely effects, such as how travel times for freeway users and for users of existing roads would be affected, the likely incidence and severity of traffic accidents, the expected impact on atmospheric pollution, and the expected loss of flora and fauna resulting from this change in land use. The second step would require putting a dollar value on each item, that is, the value of travel time saved, the value of lives lost or saved, the health cost of air pollution, and the value of the threatened species. The third step would involve expressing these various streams of costs and benefits in terms of their current value equivalent, on the assumption that future costs and benefits would have less weight than immediate costs and benefits. How much less weight depends on the choice of a discount rate. The fourth step would involve comparing the discounted costs of the freeway construction with its estimated benefits, all expressed in terms of these monetary net present values. The freeway is then deemed to be socially desirable only if the benefits exceed the costs. If two or more freeway routes were under consideration, the preferred route would be the one with the lowest cost-benefit ratio.

Supporters of cost-benefit analysis emphasize the advantages of having a method of project evaluation that increases the consistency of decision-making. Its critics challenge the legitimacy of placing monetary values on 'intangibles' like environmental quality even on itself. Cost-benefit analysis shares with neoclassical welfare economics a distinctive set of assumptions about the nature of the economy and society. It is a monetary calculus of the determinants of community well-being, for better or worse.

This adds up to a quite considerable indictment of free-market capitalism within a body of analysis predisposed to favour the market. The acknowledgement of the various sources of 'market failure' provides a strong rationale for trying to rectify the recurrent problems of markets by developing appropriate government policies. This is the liberal-interventionist position. It has usually been embraced by economists seeking a compromise between their professional adherence to neoclassical theory and their personal commitment to economic reform and social progress. It is associated with the use of techniques like cost-benefit analysis (see box 23.1) to decide the 'what', 'when', and 'who' of public expenditure and the appropriate regulation of private-sector development.

However, the liberal-interventionist position has always had its critics among other neoclassical economists concerned to maintain the faith in the free-enterprise system. They warn of the greater economic, social, and political problems that may result from such attempts at steering or regulation. In the last two decades, this purist position has gained strength. It has become the predominant orthodoxy, variously labelled 'neo-liberalism', 'economic rationalism', and 'economic fundamentalism'. Its conceptual benchmark is the notion of 'government failure'.

GOVERNMENT FAILURE

Scepticism about government is a long tradition with various manifestations, both popular and academic. Politically, it has a basis in anarchist thought as well as right-wing libertarianism. The latter viewpoint derives in part from social Darwinism; it sees the 'struggle for existence' and the 'survival of the fittest' as elements in a natural order, which governments should not spoil by attempting to seduce economic inequality and other social problems. The persuasion to government also rests in popular folklore, particularly in the United States, about the advantages of living in a society that promotes individualism rather than seeking the redress of its problems through collective action. Anyone can make it 'from rags to riches' by individual initiative, according to this view. Governments, however well intentioned, stand in the way of such drives for personal advancement in a 'free society'. Worse, they tend to be parasitic and/or corrupt.

Developments in orthodox economics during the last two decades have given some academic legitimacy to these popular perceptions. Public-choice theory is particularly significant in this respect. It has been an increasingly influential current of thought running between neoclassical economics and political science. It represents politicians and bureaucrats as subjects of Homo economicus, self-interested individuals whose actions are calculated responses to vote-maximizing processes. They tend to implement policies to satisfy the demands (and secure the votes) of sectional interest groups, systematically violating the broader national interest. Macroeconomics was the turf protection they seek, union security minimum wage legislation, housing tenure secure rent control, and so forth. However, the result is not conducive to the economic welfare of society as a whole. On the contrary, the overall effect is an incoherent series of regulations and policy interventions that impede the capacity of the market to create an efficient allocation of resources.